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*TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION*  
*Office of Inspections and Evaluations*



*Additional Enhancements Could Further  
Strengthen Lockbox Bank Oversight*

**September 8, 2008**

**Reference Number: 2008-IE-R001**

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

September 8, 2008

**MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION**

**FROM:**

Philip Shropshire

Acting Deputy Inspector General for Inspections and Evaluations

**SUBJECT:**

Final Inspection Report – Additional Enhancements Could Further  
Strengthen Lockbox Bank Oversight (200810IE004 formerly  
Audit # 200730006)

This report presents the results of our inspection to evaluate the controls established to process payments received in lockbox banks.

*Impact on the Taxpayer*

The Internal Revenue Service (IRS) uses lockbox banks to receive and process taxpayers' payment vouchers and remittances in order to accelerate deposits. Our limited tests showed that some individuals might have received an extension of time to file and been erroneously credited with timely payments. If a taxpayer receives an extension of time to file in error, the failure to file and failure to pay penalties are avoided. Penalties are imposed to encourage voluntary compliance and should be consistently applied.

*Synopsis*

During 2001, about 78,000 income tax payments valued at \$1.2 billion were lost or destroyed at a lockbox facility. In January 2003, the Government Accountability Office issued a report on the lockbox banks and found significant security and processing control weaknesses. The IRS agreed with the findings presented in that report and initiated corrective actions.

Overall, the IRS has implemented extensive review processes to provide lockbox oversight. First, IRS Lockbox Field Coordinators perform complete procedural and internal control reviews on-site during April peak processing. Second, at the submission processing campus, the IRS Program Analyst System (PAS) function performs additional lockbox processing quality



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reviews. Despite these extensive reviews, we did identify a small number of cases that might have been incorrectly processed as having been received in a timely manner.

For example, we found that some payments received with an Application for Automatic Extension of Time to File U.S. Individual Income Tax Return (Form 4868) were sometimes processed to the taxpayer's IRS account with a timely transaction date, with the extension approved contrary to evidence provided by the processing date of the taxpayer's check. Specifically, the taxpayer's check that accompanied the extension was 1) not processed until the first or second week of May, 2) dated after the April 15<sup>th</sup> extension due date, and 3) in some cases, stamped as untimely. Generally, a payment associated with an extension that was filed on-time would be processed very near the extension received date.

The IRS does have a control procedure in place to identify this condition. An automated program identifies when extensions and the associated remittances show a timing delay. If the delay exceeds the tolerance, the cases are rejected in order that they might be further reviewed. However, current lockbox processing procedures do not require either a date stamp or some other evidence to clearly show the extension received date. Without this evidence, it is very difficult to determine if the cases were correctly processed.

Furthermore, the function that processes the rejected cases has procedures that do not clearly explain how to resolve the discrepancy between an approved extension and a late payment date. Consequently, in some cases the extensions were allowed by applying an on-time filed date to the account, while in others the payments were processed with a late date and the extensions were disallowed.

### *Recommendations*

We recommend that the Director, Submission Processing—who is the IRS executive responsible for lockbox operations—ensure that next years' reviews emphasize the review of potentially late-filed extensions. If patterns similar to those we observed are found, consider the need to revise the PAS review procedures. We also recommend that the Director, Submission Processing ensure that the instructions detailing how to process rejected extensions are clarified. These procedures would help ensure more accurate and consistent extension processing.

### *Response*

IRS management agreed to both of our recommendations. They will develop and pilot the recommendation in PAS to evaluate whether the review will be beneficial, and they have already added instructions for processing rejected extensions. Management's complete response to the draft report is included as Appendix IV.



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Copies of this report are also being sent to the IRS managers affected by the report recommendations.

Please contact me at (202) 927-7048 if you have questions.

Attachment



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### *Abbreviations*

FMS	Financial Management Service
IDRS	Integrated Data Retrieval System
IRS	Internal Revenue Service
PAS	Program Analyst System
RTR	Remittance Transaction Research



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### *Background*

The IRS has used lockbox banks since 1985 to process taxpayer payment vouchers and the associated remittances to accelerate deposits. Today the IRS lockbox network is configured with three commercial banks that receive tax forms and payments at eight lockbox sites in support of IRS submission processing campuses.<sup>1</sup>

The IRS lockbox network processed over 67 million payments totaling in excess of \$400 billion during Fiscal Year 2007. Commercial depositories that operate lockboxes are chosen through a process initiated by the IRS and directed by the Financial Management Service (FMS), a Bureau of the Department of the Treasury. The banks must meet requirements outlined in the Lockbox Processing Guidelines and the Lockbox Security Guidelines, written and maintained by the IRS. The Director, Submission Processing, is the IRS executive responsible for lockbox operations.

Lockbox banks are required to deposit all payments received in a single day by the next day's deposit cut-off whenever possible. However, during 2001, about 78,000 income tax payments valued at \$1.2 billion were lost or destroyed at a lockbox facility. In January 2003, the Government Accountability Office issued a report<sup>2</sup> on the lockbox banks and found significant security and processing control weaknesses. The IRS agreed with the findings presented in that report and initiated corrective actions.

We reviewed data processed nationwide and performed review procedures at the Submission Processing Campuses in Chamblee (Atlanta), Georgia, and Andover, Massachusetts, and the lockbox bank sites in College Park, Georgia, and Windsor, Connecticut, during the period September 2007 through March 2008. The review was performed in accordance with the President's Council on Integrity and Efficiency Quality Standards for Inspections.<sup>3</sup> Detailed information on our inspection objectives, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

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<sup>1</sup> The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

<sup>2</sup> *IRS Lockbox Banks: More Effective Oversight, Stronger Controls and Further Study Are Needed* (GAO-03-299, dated January 2003)

<sup>3</sup> We conducted this performance inspection in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the inspection to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our inspection objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our inspection objectives. Because this report was prepared by the TIGTA Office of Inspections and Evaluations, we cite the President's Council on Integrity and Efficiency Quality Standards for Inspections as the authoritative standards that were followed.



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### *Results*

Overall, the IRS has implemented extensive review processes to provide lockbox oversight. First, IRS Lockbox Field Coordinators perform complete procedural and internal control reviews on-site during April peak processing.<sup>4</sup> Second, at the submission processing campus, the IRS Program Analyst System<sup>5</sup> (PAS) Unit performs additional lockbox processing quality reviews. Despite these extensive reviews, we did identify a small number of cases that might have been incorrectly processed as having been received in a timely manner.

We found that some payments received with an Application for Automatic Extension of Time to File U.S. Individual Income Tax Return (Form 4868)<sup>6</sup> (hereafter referred to as an extension) were sometimes processed to the taxpayer's IRS account with a timely transaction date, with the extension approved contrary to evidence provided by the processing date of the taxpayer's check. Specifically, the taxpayer's check that accompanied the extension was not processed until the first or second week of May, dated after the April 15<sup>th</sup> extension due date, and in some cases, stamped as untimely.

Furthermore, the function that processes the rejected cases has procedures that do not clearly explain how to resolve the discrepancy between an approved extension and a late payment date. Consequently, in some cases the extensions were allowed by applying an on-time filed date to the account, while in others the payments were processed with a late date and the extensions were disallowed. The detailed results follow.

### ***The IRS Has Implemented Extensive Reviews to Provide Lockbox Bank Oversight, but Further Action Is Needed***

#### ***The IRS has implemented extensive reviews to provide lockbox bank oversight***

The IRS Lockbox Field Coordinators (hereafter referred to as Coordinators) assigned to each lockbox site monitor inventories and production on a daily basis. During peak processing times, the Coordinators perform on-site quality reviews and assess internal control. The reviews are intended to ensure that the lockbox banks meet the standards in the Lockbox Processing Guidelines and focus on the critical elements that could cause a work stoppage if processing is not accurate.

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<sup>4</sup> Peak processing times for the lockboxes are around the April 15<sup>th</sup> individual taxpayer return due date.

<sup>5</sup> A method for identifying systemic deficiencies through review of the work. In January 2008, the name was changed to the Improvement Unit.

<sup>6</sup> The Form 4868 is used by taxpayer's to request additional time to file an individual tax return. The Form 4868 must be submitted by April 15<sup>th</sup> for most taxpayers. If the taxpayer anticipates owing money, the IRS encourages that a payment also be submitted to avoid interest and penalties.





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Among other things, the Coordinators:

- review mail to ensure that it is properly tagged with the date and time received, correctly sorted by tax type, and properly sequenced in date and time order.
- review vouchers and checks to ensure that they are batched correctly and that the correct processing information is associated with each batch.
- analyze a sample of the items to be shredded after processing to ensure that no pertinent taxpayer information or requests have been overlooked before the items are destroyed.
- perform a facility check by searching for unprocessed vouchers and checks in areas where mail was housed or processed before declaring that all peak processing has been successfully completed.

### **Program Analyst System reviews could be strengthened to ensure accurate returns processing**

A PAS Unit procedure designed to ensure that remittances are properly posted might not ensure that the extension-received dates are accurate. For each day mail is received, the lockbox site staff pulls a random sample of eight envelopes. The lockbox staff reviews the sample documents, copies them, and returns the originals into the processing stream. The copies, including the postmarked envelopes, are sent to the IRS submission processing campus for review. The PAS staff compares the payment documents to the Remittance Transaction Research (RTR) System<sup>7</sup> information to verify that the remittance was processed with the correct taxpayer entity information, tax type, tax period, money amount, transaction code, and transaction date.

However, we found that some payments received with an extension were sometimes processed to the taxpayers' IRS accounts with a timely transaction date, and the extension was approved even though the check processing date was much later than the April 15<sup>th</sup> due date. We found nine payments processed at two sites in which the checks were dated after the extension due date, and the RTR system images of the processed checks and extensions—some date stamped—showed that they were received on May 7<sup>th</sup> and May 8<sup>th</sup>. Extensions are not date stamped unless they are determined to be late. However, the taxpayers' IRS accounts on the Integrated Data Retrieval System (IDRS)<sup>8</sup> showed that the extensions were processed as on-time (received by April 15<sup>th</sup>) and approved. If the applications had been processed as untimely, an additional \$191,599 in late filing and payment penalties would have been assessed.

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<sup>7</sup> The RTR consolidates remittance transaction data and images and makes them available to authorized users who need to research remittance transactions.

<sup>8</sup> The IDRS is an IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.



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We discussed these nine cases with the IRS senior staff responsible for lockbox processing, and all agreed that there is insufficient evidence to be certain that the cases were incorrectly processed. Lockbox procedures provide that if a document is initially classified as being received in a timely manner, the postmarked envelope is discarded. However, the postmarked envelopes are essential to determining whether filing was on-time for extensions received after April 15<sup>th</sup>.<sup>9</sup> The IRS's own processing procedures direct employees to use the envelope postmarks to determine the timeliness. Without the postmarked envelope or a received date stamp on the return, evidence is insufficient for determining whether an extension was filed on-time.

Because our evidence was based on limited observations, the IRS staff is reluctant to require the lock box staff to date stamp all requests for extensions received after April 15<sup>th</sup>. We acknowledge those concerns and suggest that during next year's peak processing, special emphasis should be placed on determining whether the extensions are accurately evaluated for timeliness. We also suggest that—particularly for the extensions to file—the PAS staff should compare the postmarks on the envelopes for the sampled extensions to the IDRS transaction dates to verify that the extensions are correctly processed.

### **A processing instruction should be clarified**

When payments are processed with dates that indicate late filing—but the related extension is initially accepted as having been filed in a timely manner—the case is “rejected” from processing for possible correction. Instructions to the reject function do not clearly explain how to resolve these transactions. Consequently, in some cases the extensions were allowed by applying an on-time filed date to the account, and in other identical cases the payments were processed with a late date and the extensions were disallowed.

The IRS can be confident that most returns and applications for extensions to file processed through the end of April were mailed by the due date. However, in situations in which the check is processed substantially after the return due date, the IRS does not have the information needed to determine whether the lockbox site properly processed the extension request.

## **Recommendations**

**Recommendation 1:** The Director, Submission Processing, should ensure that during next year's peak processing, the Program Analyst System daily sample reviews should include checking the taxpayers' IRS accounts on the IDRS for payment transaction dates and extensions when applications are received with payments. If PAS staff determines that the additional

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<sup>9</sup> Taxpayers generally have until April 15<sup>th</sup> to file requests for extensions. However, due to storms in April 2007, the due date to file was extended for many taxpayers.



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review is beneficial, the instructions for the daily sample review should be revised to require the staff to compare the IDRS data to data on the RTR system.

**Management's Response:** IRS management agreed to assess the recommendation. By April 2009, they will implement a pilot to evaluate whether the review would be beneficial.

**Recommendation 2:** The Director, Submission Processing, should also ensure that the reject function procedures for resolving discrepancies between approved extensions to file with a later check transaction date be clarified, so that any payments would be renumbered as payments without an extension.

**Management's Response:** IRS management agreed with the recommendation, and corrective action has already been taken. Instructions were added to the Internal Revenue Manual to address the concern we raised.



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### **Appendix I**

#### *Detailed Objective, Scope, and Methodology*

The overall objective of this review was to evaluate the adequacy of controls established to process payments received in lockbox banks.

The review was conducted using historic data to identify issues that might have resulted from inadequate controls. We extracted data on payments processed by lockbox banks from TIGTA's Data Center Warehouse and queried the data to obtain processing times by dates and amounts. We used a judgmental sample.

To accomplish our objective, we:

- I. Reviewed available guidance to determine the required processing and oversight procedures.
  - A. Reviewed Internal Revenue Manuals relating to lockbox oversight and payment processing.
  - B. Obtained and reviewed the Lockbox Processing Guide, the Lockbox Security Guide, and the Designation of Financial Agent, which is the banks' agreement with the FMS.
- II. Reviewed processing results to determine whether lockbox sites processed payments accurately and in a timely manner by comparing copies of payments to payment information posted to taxpayers' IRS accounts.
  - A. Obtained data for payments processed by lockbox banks and campuses (for comparison).
  - B. Obtained access to the RTR system for payment copies and deposit dates.
  - C. Compared payment information documents in RTR to the data posted to taxpayers' accounts on IDRS.
- III. Determined the actual payment processing procedures in place intended to ensure timely and accurate processing of payments.
  - A. Observed payment processing at lockbox sites, including internal controls.
  - B. Observed payment processing at an IRS campus to determine the controls in place for comparison to controls in place at the lockbox site.



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### **Appendix II**

#### *Major Contributors to This Report*

Kyle R. Andersen, Director, Office of Audit (Small Business and Corporate Programs)  
Kevin P. Riley, Acting Director, Office of Inspections and Evaluations  
Bernard F. Kelly, Audit Manager  
Dolores Castoro, Lead Auditor  
Gail C. Schuljan, Senior Auditor  
Linda P. Lee, Program Analyst



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**Appendix III**

*Report Distribution List*

Commissioner C  
Office of the Commissioner – Attn: Chief of Staff C  
Deputy Commissioner Services and Enforcement SE  
Deputy Commissioner, Wage and Investment Division SE:W  
Director, Customer Account Services SE:W:CAS  
Director, Submission Processing SE:W:CAS:SP  
Chief Counsel CC  
National Taxpayer Advocate TA  
Director, Office of Legislative Affairs CL:LA  
Director, Office of Program Evaluation and Risk Analysis RAS:O  
Office of Internal Control OS:CFO:CPIC:IC  
Audit Liaison  
    Deputy Commissioner Services and Enforcement SE  
    Commissioner, Wage and Investment Division SE:W



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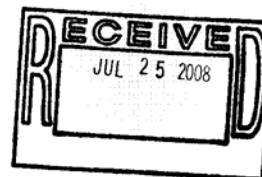
### **Appendix IV**

## *Management's Response to the Draft Report*




DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
ATLANTA, GA 30308

JUL 25 2008



MEMORANDUM FOR MICHAEL R. PHILLIPS  
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Richard Byrd, Jr.   
Commissioner, Wage and Investment Division

SUBJECT: Inspection Draft Report – Additional Enhancements Could  
Further Strengthen Lockbox Bank Oversight  
(200810IE004 formerly Audit # 200730006)

I reviewed the subject draft report and appreciate your review of our oversight of lockbox banks. As you know, these banks provide a significant service in IRS payment processing by efficiently and quickly depositing funds into the Treasury. Our lockbox network processed over 67 million payments in Fiscal Year (FY) 2007, with deposits totaling more than \$400 billion. Through May of FY 2008, our lockbox network had processed over 45 million payments with deposits totaling more than \$296 billion.

We have an extensive review process to ensure payments are credited correctly and deposited timely. The IRS has assigned IRS Lockbox Field Coordinators to monitor inventories and production on a daily basis, and to perform procedural and internal control reviews at the lockbox sites. These Coordinators conduct onsite quality reviews and assessments of internal controls during peak processing times. They also review mail to ensure the received date and time are properly identified and the returns are properly sorted by tax type. The Program Analysis System Unit performs additional quality reviews of sample documents and postmarked envelopes.

We have already added instructions to Internal Revenue Manual (IRM) 3.12.10, Revenue Receipts, to address the concern over the reject functions procedures for resolving discrepancies between an approved extension to file with a later check transaction date so that these payments will be renumbered as payments without an extension.

Our comments to your recommendations are attached. If you have any questions regarding this response, please call me at (404) 338-7060, or members of your staff may contact Peter J. Stipek, Director, Customer Account Services, at (404) 338-8910.

Attachment





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Attachment

### **RECOMMENDATION 1**

The Director, Submission Processing should ensure that during next year's peak processing, the Program Analyst System (PAS) daily sample reviews should include checking the taxpayers' IRS accounts on the Integrated Data Retrieval System (IDRS) for payment transaction dates and extensions when applications are received with payments. If PAS staff determines that the additional review is beneficial, the instructions for the daily sample review should be revised to require the staff to compare the IDRS data to data on the Remittance Transaction Research (RTR) system.

### **CORRECTIVE ACTION**

Submission Processing agrees to evaluate this recommendation. To assist in the evaluation process, we will develop and pilot this recommendation by April 2009, to determine if this review is beneficial. The tentative date for completion and any resulting solution will be September 30, 2009.

### **IMPLEMENTATION DATE**

October 15, 2009

### **RESPONSIBLE OFFICIAL**

Director, Submission Processing, Wage and Investment Division

### **CORRECTIVE ACTION MONITORING PLAN**

We will monitor this corrective action as part of our internal management control system.

### **RECOMMENDATION 2**

The Director, Submission Processing should also ensure that the reject function procedures for resolving discrepancies between approved extensions to file with a later check transaction date be clarified, so that any payments would be renumbered as payments without an extension.

### **CORRECTIVE ACTION**

We agree with this recommendation and corrective action has already been taken. Instructions were added to Internal Revenue Manual 3.12.10, Revenue Receipts, addressing this concern. In addition, Hot Topic OG-QA-2002-325; 2008, was issued May 20, 2008, alerting the staff to the revision.

### **IMPLEMENTATION DATE**

Completed

### **RESPONSIBLE OFFICIAL**

N/A

### **CORRECTIVE ACTION MONITORING PLAN**

N/A